

2 Theoretical Foundation and Institutional Environment

This thesis examines the influence of blockholders on agency costs and firm value of German listed firms from an agency theoretic perspective. As a result, the following basic questions arise: 1) What is meant by the term “agency theory” and what are its propositions? 2) How do agency costs arise and what different types of agency costs exist in listed firms? 3) Are there any mechanisms that can be used to mitigate agency costs? 4) What is the role of the German institutional environment within this analysis? The sections that follow are organized around these questions germane to the present research. Section 2.1 provides a definition of agency theory and introduces different types of agency conflicts and the resulting agency costs. Moreover, it elucidates corporate governance and its mechanisms as instruments to mitigate agency costs. Section 2.2 then provides an analysis of the institutional environment in which the firms and their blockholders operate. Finally, section 2.3 covers the institutional environment in the EU, in particular two contemporary regulatory developments that had an impact on the research design of this thesis. Section 2.4 provides a résumé.

2.1 Agency Theory

The corporate form, characterized by a separation of ownership and control, has consistently proven to constitute a superior business organization.⁵⁷ However, the corporation has not existed and functioned without deficiencies. The numerous problems arising from the agency nature of the different relationships within the corporate form have continuously constrained its economic effectiveness. The goal of this part is to provide a basic understanding of these relationships and the resulting problems.

Therefore, section 2.1.1 first introduces the agency theory, its definitions, and key elements. Sections 2.1.2–2.1.4 present the different types of agency conflicts and the resulting agency problems inherent in the corporate form and relevant in the context of this thesis. While the presence of agency problems is considered a fact by classic agency theory, it remains vague regarding the nature of the problems.⁵⁸ Therefore, the sections provide examples of the manifestation of the respective agency conflicts. Although the agency theory is “the dominant theme of empirical examinations of the relationship between equity ownership and financial performance”⁵⁹, its adequacy and applicability in the present context should still be illustrated. Hence, these sections also aim to clarify whether one can reasonably presume the presence of agency conflicts within the respective relationships altogether. Section 2.1.5 then introduces the concept of agency costs as a direct result of the agency problems. In the presence of these agency theoretic relationships and the problems and costs they bring along, the question is how to ensure an effective and efficient operation of the corporate form. Corporate governance, regarded as an instrument to ensure this effective and efficient operation, is covered in section 2.1.6.

⁵⁷ See also Bhagat/Jeffers Jr. (2002): 13.

⁵⁸ See Shapiro (2005): 279.

⁵⁹ Dalton et al. (2003): 13.

2.1.1 Foundations of Agency Theory

The agency theory, together with the property rights and transaction cost theory, constitutes the theoretical structure of the new institutional economics.⁶⁰ Therefore, it makes sense to shortly introduce and demarcate the new institutional economics as well as the property rights and transaction cost theory in section 2.1.1.1 before probing into the agency theory within section 2.1.1.2.

2.1.1.1 New Institutional Economics

The new institutional economics sets itself the goal of explicating the reasons for the existence of (economic) institutions⁶¹, their purpose, and to “demonstrate that institutions are susceptible to analysis.”⁶² It traces back to the seminal paper “The Nature of the Firm” by *Coase* (1937). Within this paper, he raises the question of why firms⁶³ exist, given that “if production is regulated by price movements, production could be carried on without any organization at all.”⁶⁴ He proposes that the major reasons for the establishment of a firm are the costs of using the price mechanism of the external market,⁶⁵ i.e. transaction costs. He argues that by the establishment of an organization, transaction costs can be lowered.⁶⁶ These thoughts have been neglected until the early seventies.⁶⁷ At this time, researchers were taking up the thoughts of *Coase*, forming the foundation for the new institutional economics.⁶⁸ For example, *Williamson* (1971) proposes that internal organizations offer advantages relative to the market due to a number of beneficial internal properties and “transactional failures”⁶⁹ in the operation of external markets. With regard to the former, internal organization mitigates aggressive bargaining, possesses efficient conflict resolution mechanisms and offers informational advantages⁷⁰. In addition, internal organization attenuates failures of the external market that result in transaction costs, such as contractual incompleteness and a defective specification of property rights.⁷¹ Hence, organizations are regarded as “a means of achieving the benefits of collective action in situations in which the price system fails.”⁷²

⁶⁰ See Witt (2001): 85. See also Ampenberger (2010): 37.

⁶¹ North (1991): 97 defines institutions as “the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights).”

⁶² Williamson (1998): 25. See also Richter (1994): 3.

⁶³ While *Coase* (1937) does not provide an exact definition of the firm, *Williamson* (2000): 602 states that within new institutional economics, it is necessary “to consider the firm as a governance structure (which is an organizational construction) in which internal structure has economic purpose and effect.”

⁶⁴ *Coase* (1937): 388.

⁶⁵ With this assumption, the new institutional economics abandoned the proposition of perfect markets, being the cornerstone of the neoclassic financial theory. See *Wolf* (1999): 7f.

⁶⁶ See *Coase* (1937): 392. Later, authors realized that there is a replacement of the transaction costs existing on the market by the costs of intra-firm transfers. See *Arrow* (1969): 1. See also *Williamson* (1971).

⁶⁷ See also *Williamson* (1971): 122.

⁶⁸ Prominent contributions are e.g. *Alchian/Demsetz* (1972); *Arrow* (1974); *Williamson* (1976); *Klein/Crawford/Alchian* (1978).

⁶⁹ *Williamson* (1971): 112.

⁷⁰ Informational advantages refer to the capacity of intra-organizational information channels to bundle and code information for retransmission, thereby lowering information costs. See *Arrow* (1974): 37, 53-55.

⁷¹ See *Williamson* (1971): 113f and *Williamson* (1981): 559.

⁷² *Arrow* (1974): 33.

Within the context of new institutional economics, *Williamson* (1998, 2000) distinguishes four levels of social analysis as depicted in figure 15 (appendix 1). Level one represents the social embeddedness level, constituting norms, customs, traditions and culture, and is generally taken as given by most researchers. Level two represents the institutional environment and provides the “rules of the game”⁷³ wherein economic activity occurs. Within this level, the theory of property rights is the most important analytic tool. The institutions of governance are situated within level three which deals with the “play of the game”⁷⁴ and strives to set up efficient governance structures. Transaction cost economics operate within this level. Finally, level four deals with resource allocations and the optimization of marginal conditions. Agency theory is concerned with this level.⁷⁵

As shown in figure 15, new institutional economics is concerned with an analysis and efficient set-up of the institutional environment. The **property rights theory** investigates the relationship between institutions and property rights in search for potential welfare gains.⁷⁶ Property rights theorists stress that a certain good should be defined according to its associated property rights.⁷⁷ They further posit that “it is the ownership of the rights associated with the resources which constitutes the economic value of the resources.”⁷⁸ Property rights are regarded “as the means by which to realize superior economic performance”⁷⁹. In this context, property rights are not defined as the ownership of a resource but rather as the right to use a resource.⁸⁰ Hence, the owner of a property right does not own the resource itself, but rather a bundle or a part of the rights to use a particular resource.⁸¹ Since this bundle of rights is divisible, more than a single individual can own some rights in a particular resource.⁸² In order to explain the behavior of the firm⁸³, the property rights theory focuses on the effort of individuals within the organization to maximize their utility.⁸⁴ Individual utility maximization is thus one characteristic feature of the property rights theory. Transaction costs represent another characteristic feature. If property rights could be freely exchanged or transferred, i.e. in the absence of transaction costs, the identity of the owner and thus the distribution of property

⁷³ Williamson (1998): 27.

⁷⁴ Williamson (1998): 29.

⁷⁵ For more details on the figure, see Williamson (1998): 25-29 and Williamson (2000): 596-600.

⁷⁶ See also Furubotn/Richter (1991): 2. According to de Alessi (1991): 47, the distribution of property rights can have significant welfare implications.

⁷⁷ This is also pointed out by Furubotn/Richter (1991): 5.

⁷⁸ Kaulmann (1987): 443. See also Furubotn/Pejovich (1972): 1139.

⁷⁹ Williamson (1998): 28. See also Furubotn/Pejovich (1972): 1141; Neus (1989): 9.

⁸⁰ According to Furubotn/Pejovich (1972): 1140, the right of ownership entails “the right to use it, to change its form and substance, and to transfer all rights in the asset”.

⁸¹ More specifically, property rights can be divided into three categories: *usus* – the right to use the property; *abusus* – the right to change, modify or destroy the property; and *fructus* – the right to enjoy benefits arising from the property. See Kaulmann (1987): 733.

⁸² See Demsetz (1967): 347; Furubotn/Pejovich (1972): 1140; Alchian/Demsetz (1973): 17f. However, the value and the efficient use of a resource decrease with the number of individuals among which the property rights are distributed. See Kaulmann (1987): 444.

⁸³ Within the theory of property rights, the firm is defined as a “set of contracts among factors of production, with each factor motivated by its self-interest.” Fama (1980): 289.

⁸⁴ The theory accounts for the fact that also nonpecuniary goods constitute elements in managers’ utility functions. See Furubotn/Pejovich (1972): 1137f, 1147. Hence, it rejects profit maximization as the primary explanation of decision makers’ actions and thereby contributes to explaining why firms frequently abandon the traditional goal of profit maximization. See Furubotn/Pejovich (1972): 1149.

rights would be irrelevant.⁸⁵ Those who can put the resource to its most effective use can easily negotiate with those currently in possession of the property rights. However, if the exchange causes costs, “then an alteration in the identity of the ownership rights’ possessor can have allocative effects.”⁸⁶ That is, in the presence of transaction costs, the organization and distribution of a resource’s property rights influence the behavior of individuals interacting with this resource.⁸⁷

Due to the importance of transaction costs, **transaction cost theory** studies their effect on economic relations.⁸⁸ It focuses on efficiency improvements by making the transactions the focus of analysis, which are defined as negotiated transfers of property rights.⁸⁹ Because any transaction causes costs, the effectiveness of organizations and mechanisms should be assessed based on their respective transaction costs.⁹⁰ These comprise all costs related to (1) “the creation or change of an institution or organization”⁹¹ and (2) “the use of the institution or organization”⁹². The second type of costs consists of “the costs of arranging a contract ex ante and monitoring and enforcing it ex post”.⁹³ Specific investments or sunk costs arising as a result of the establishment of an institutional framework comprise the fixed component of transaction costs. The variable component contains the costs associated with the use of the institution: (1) the costs of initiating the contract (information costs and search costs),⁹⁴ (2) the costs of completing the contract (negotiation and decision costs)⁹⁵ and (3) monitoring and enforcement costs.⁹⁶ The size of transaction costs is affected by bounded rationality,⁹⁷ opportunism⁹⁸ and a set of transaction characteristics⁹⁹: the transaction’s frequency, its uncertainty, information asymmetries and asset specificity.¹⁰⁰ Transactions, differing with regard to these dimensions, can be adjusted through governance structures¹⁰¹ to favorably affect transaction costs.¹⁰² Accordingly, *Williamson* (1998) describes the major problem of organizations as “aligning transactions with governance structures in order to generate a high performance re-

⁸⁵ See Alchian/Demsetz (1973): 22. See also Coase (1960) and Demsetz (1967): 349.

⁸⁶ Alchian/Demsetz (1973): 22.

⁸⁷ See Kaulmann (1987): 444.

⁸⁸ See Wolf (1999): 9. In the terminology used above, transaction costs theory deals with the play of the game.

⁸⁹ See Seger (1997): 18.

⁹⁰ See Seger (1997): 20.

⁹¹ Furubotn/Richter (1991): 8f.

⁹² Furubotn/Richter (1991): 8f. According to the authors, the focus of existing literature so far has been primarily on the second type of costs.

⁹³ Matthews (1986): 906. This view is shared by Furubotn/Richter (1991): 9.

⁹⁴ See Richter (1994): 6. See also Furubotn/Richter (1991): 9. Search costs refer, for example, to the costs associated with the search for potential managerial candidates.

⁹⁵ The costs involve direct costs (e.g. lawyer), or indirect costs (e.g. opportunity costs). See Richter (1994): 7.

⁹⁶ See Richter (1994): 7.

⁹⁷ Bounded rationality refers to “behavior that is intendedly rational but only limitedly so.” *Williamson* (1998): 30.

⁹⁸ For a definition of opportunism, see FN 178 below.

⁹⁹ See *Williamson* (1973): 317f.

¹⁰⁰ See *Williamson* (1973): 318; *Williamson* (1998): 36. See also Richter (1994): 6; Wolf (1999): 10. Asset specificity refers to “the degree to which durable, transaction-specific investments are required to realize least cost supply.” *Williamson* (1981): 555.

¹⁰¹ Of all governance structures, firms and markets are the primary alternatives. See *Williamson* (1981): 549.

¹⁰² See *Williamson* (1998): 37.

sult.”¹⁰³ Transaction cost theory addresses this problem and examines governance structures with regard to their capability to diminish transaction costs and matches these structures with transactions in a transaction cost minimizing way.¹⁰⁴

2.1.1.2 Definitions and Elements of Agency Theory

In analyzing the behavior of individuals that enter a relationship, agency theory takes up a number of issues raised within the property rights and transaction cost theory. Although it still regards an organization as a “nexus of contracts”¹⁰⁵, it extends this definition and views the organization “as a team whose members act from self-interest but realize that their destinies depend to some extent on the survival of the team in its competition with other teams.”¹⁰⁶ While the agent personifies both the firm’s manager and the bearer of the residual risk within the property rights theory,¹⁰⁷ agency theory separates these concepts and observes that the underlying ownership rights (e.g. control and income) within the modern organization are partitioned and distributed among different individuals.¹⁰⁸ The primary advantage of distinguishing management and risk bearing is the recognition that each is “faced with a market for its services that provides alternative opportunities and, in the case of management, motivation toward performance.”¹⁰⁹ According to the property rights theory, the distribution and specification of property rights determine the allocation of costs and benefits across individuals. As the specification of these property rights is done via contracting, the behavior of the involved parties will depend on these contracts. The agency theory takes up these contracts and focuses on their behavioral implications for the interaction between principal and agent.¹¹⁰ Agency theory also finds the presence of transaction costs to significantly impede the design of effective contractual provisions governing the interaction between principal and agent.¹¹¹ Moreover, agency costs¹¹² constitute a form of transaction costs, as they are a direct result of the use of an institution.¹¹³

In general terms, agency theory describes and explains the behavior of individuals that enter into a relationship in an environment characterized by the presence of external influences, divergent interests and asymmetric information.¹¹⁴ Specifically, the object of study constitutes the situation where one player, the principal, delegates tasks to another player, the agent, in

¹⁰³ Williamson (1998): 40.

¹⁰⁴ See Williamson (1981): 549, 553.

¹⁰⁵ Fama (1980): 290. See also Jensen/Meckling (1976): 310.

¹⁰⁶ Fama (1980): 289.

¹⁰⁷ In property rights theory, this person is also called entrepreneur or employer. See Fama (1980): 289.

¹⁰⁸ See also Jensen/Meckling (1976): 311; Fama (1980): 289, 291; Furubotn/Richter (1991): 10. Fama (1980): 289 suggests that the disregard of ownership and control by the property rights theory constitutes the explanation for the failure of this literature to explain the large modern corporation.

¹⁰⁹ Fama (1980): 291. He states that the market faced by risk bearers is the capital market, enabling them to shift among different firms (teams) and to hedge against failure of any firm (team) through diversification.

¹¹⁰ See also Jensen/Meckling (1976): 308.

¹¹¹ See also Furubotn/Richter (1991): 10.

¹¹² Please see section 2.1.5 for an explanation of agency costs.

¹¹³ See also Molho (1997): 120.

¹¹⁴ See Grossmann/Hart (1983): 9; Spremann (1987): 3; Saam (2002): 2f.

order for the agent to complete these tasks for him.¹¹⁵ Given certain assumptions about people, organizations and information distribution, agency theory examines the contractual provisions governing the interaction between principal and agent,¹¹⁶ analyzes typical problems¹¹⁷ within the relationship, and debates mechanisms to anticipate and mitigate problems to ensure that the agent effectively and efficiently works on behalf of the principal.¹¹⁸ The resulting solution is said to be Pareto-optimal in the sense that no other contract design can increase the welfare of one player without decreasing the welfare of the other.¹¹⁹

Within the agency theory, one can distinguish between two branches of research, the positivist and the normative agency theory.¹²⁰ While both branches focus on the contract between the principal and the agent and share the underlying assumptions, they differ with regard to their research approach.¹²¹ The **positivist agency theory** is largely descriptive and empirically oriented. It tries to detect principal-agent relationships within organizations and describes and analyzes solutions for the resulting agency problems.¹²² Thereby, it typically uses empirical analyses to provide evidence of its descriptive assumptions. In contrast, the **normative agency theory** uses mathematical models and derivations to abstractedly model agency problems and focuses on the description of how the principal's and agent's preferences, the type of uncertainty and the information available to both parties affect the development of an efficient contract.¹²³ The study at hand focuses on the positivist agency theory.

The use of agency theoretic propositions to describe interactions between individuals depends on the presence of an agency relationship between these individuals. However, theorists disagree on how the delegation of control within the relationship is to be interpreted. While some authors require control to be formally delegated, others regard the informal delegation of control as a sufficient requirement for an agency relationship to arise. Thus, definitions of agency relationships can best be differentiated along the dimension of a formal delegation (narrow definition) and an informal delegation (broad definition) of control. The **narrow definition** implies an explicit delegation of authority from the principal to the agent via a contract. *Jost* (2001) regards the contract as a key component of the principal-agent relationship which he defines as an explicit bilateral agreement between the principal and the agent, specifying con-

¹¹⁵ See Saam (2002): 8. See also Thomsen/Pedersen (2000): 690.

¹¹⁶ See Eisenhardt (1989): 58. See also Meinhövel (1999): 7.

¹¹⁷ These problems are so-called agency problems which may be defined as "productive inefficiencies" resulting from conflicting interests among parties within a firm. See Barnea/Haugen/Senbet (1985): Preface.

¹¹⁸ See Rees (1985a): 3; Eisenhardt (1989): 58; Pratt/Zeckhauser (1991): Preface; Sappington (1991): 45; Saam (2002): 2f, 6, 9. In the words of Rees (1985a): 3, the main purpose of the principal agent theory is "to characterize the optimal forms of such contracts under various assumptions about the information P (author's note: the principal) and A (author's note: the agent) possess or can acquire and thereby, hopefully, to explain the characteristics of such contracts which are actually observed."

¹¹⁹ See Barnea et al. (1985): 26; Molho (1997): 5. As the first-best solution to the agency problem can only be achieved in an unrealistic world with costless information, the outcome is called second-best. See Holmström (1979): 74; Pratt/Zeckhauser (1991): 3; Wolf (1999): 19.

¹²⁰ For a more detailed analysis of the two branches, please see Jensen (1983) or Meinhövel (1999): 323.

¹²¹ See also Eisenhardt (1989): 59.

¹²² See e.g. Eisenhardt (1989): 58; Neus (1989): 14; Saam (2002): 9f. Seminal papers belonging to this branch include Jensen/Meckling (1976), Fama (1980), Fama/Jensen (1983a), Fama/Jensen (1983b), to name a few.

¹²³ See e.g. Eisenhardt (1989): 60; Neus (1989): 12; Meinhövel (1999): 24; Saam (2002): 10. Seminal papers include Ross (1973); Holmström (1979); Shavell (1979); Holmstrom (1982); Arrow (1985). Both Holmstrom (1982) and Arrow (1985) apply agency theory to the work in teams.

tingencies likely to occur during their relationship.¹²⁴ According to *Sappington* (1991), for an agency relationship to arise, “the ‘principal’ is obliged to hire an ‘agent’ with specialized skills or knowledge to perform the task in question”¹²⁵. Based on *Barnea/Haugen/Senbet* (1981), agency problems “exist when a principal, or a group of principals, employs an agent to perform a service which necessitates delegating decision making authority to the agent.”¹²⁶ *Perrow* (1986) defines an agency relationship as a contract between a principal and an agent. The latter contracts to perform certain activities for the principal, who in turn contracts to reward the agent for performing the activities.¹²⁷ *Meinhövel* (1999) argues that an agency relationship only arises if a specific contract has been signed between the involved parties.¹²⁸ *Jensen/Meckling* (1976) define the agency relationship as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.”¹²⁹ However, they point to “the generality of the agency problem”, arguing that “agency costs arise in any situation involving cooperative effort [...] by two or more people even though there is no clear cut principal-agent relationship.”¹³⁰

This view is shared by proponents of the **broad definition** of agency relationships which does not require an explicit, contractual delegation of authority but focuses on the existence of interdependencies between the involved parties. For example, *Schmidt* (1987) views an agency situation as the result of an interaction between people with different information, different options to choose from, and some shared or distinct goals. Within this interaction, one party (the principal) is affected by the behavior of the other party (the agent).¹³¹ According to *Blickle* (1987), agency theory applies to “any situation in which the outcome of the cooperation of principal and agent depends both on the random state of nature and on the action or effort chosen by the agent which is unknown to the principal.”¹³² Also *Spremann* (1987) describes the agency relationship as cooperation between two individuals in which “one of them, the agent, is decision making. He is thus affecting his own welfare and, in addition, that of the other individual called principal.”¹³³ Similar to *Spremann* (1987), *Arrow* (1991) regards the presence of two individuals as a typical element of a principal-agent relation: “One (the agent) must choose an action from a number of alternative possibilities. The action affects the welfare of both the agent and another person, the principal.”¹³⁴ Based on *Eisenhardt* (1989), agency theory describes relationships “that mirror the basic agency structure of a principal and an agent who are engaged in cooperative behavior, but have differing goals and differing

¹²⁴ See Jost (2001): 13.

¹²⁵ Sappington (1991): 45.

¹²⁶ Barnea/Haugen/Senbet (1981): 8.

¹²⁷ See Perrow (1986): 12.

¹²⁸ See Meinhövel (1999): 28, 30. See also Hartmann-Wendels (1991): 145.

¹²⁹ Jensen/Meckling (1976): 308.

¹³⁰ Jensen/Meckling (1976): 309.

¹³¹ See Schmidt (1987): 500f.

¹³² Blickle (1987): 93.

¹³³ Spremann (1987): 3. For a similar definition, see also Wilhelm (1987): 180.

¹³⁴ Arrow (1991): 37.

attitudes toward risk.”¹³⁵ A very broad definition is used by *Pratt/Zeckhauser* (1991) who state that “whenever one individual depends on the action of another, an agency relationship arises. The individual taking the action is called the agent. The affected party is the principal.”¹³⁶ In line with *Ross* (1973) and consistent with the broad definition, this thesis defines an agency relationship as an interaction between two or more parties in which “one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal, in a particular domain of decision problems.”¹³⁷

Independent of the definition of an agency relationship, an analysis of the latter is theoretically trivial if information is distributed symmetrically¹³⁸ and/or is freely available¹³⁹ and contracts can be drawn up and enforced at no cost. In this case, any agency problem arising within the agency relationship can be easily eliminated through the design of a contract that specifies the agent’s exact tasks and responsibilities for every state of nature.¹⁴⁰ However, this does not provide an accurate description of the reality. Therefore, agency theory formulates the following propositions that represent the major elements of agency theory.

In their analyses, agency theorists presuppose **rational behavior** of all parties involved. Rational behavior refers to actions with the goal to improve the players’ current personal situation and at the same time recognizing these motivations in the behavior of others and taking them into account when making decisions.¹⁴¹ When confronted with a number of alternatives, a rational player within the agency relationship is able to form expectations concerning the impact of agency problems on his personal wealth and chooses the alternative that provides him with the greatest utility, given the respective circumstances and constraints.¹⁴² In the context of the positivist agency theory, researchers assume bounded rationality. This concept accounts for the limited human ability to process information and explains why contracts between principals and agents are unavoidably incomplete.¹⁴³

A pivotal assumption of agency theory is the presence of **information asymmetries** between principal and agent. Due to the presence of transaction costs, information does not flow costlessly and is rarely freely available to all parties within the agency relationship.¹⁴⁴ As a result, the principal either is not able or incurs tremendous costs to monitor the characteristics, actions, information (knowledge) and intentions of the agent.¹⁴⁵ Thus, information asymmetries arise between the informed agent and the uninformed principal with regard to these four as-

¹³⁵ Eisenhardt (1989): 59.

¹³⁶ Pratt/Zeckhauser (1991): 2.

¹³⁷ Ross (1973): 134. See also Levinthal (1988): 155.

¹³⁸ See Meinhövel (1999): 15. Arrow (1969): 7 states that “the critical impact of information on the optimal allocation of risk bearing is not merely its presence or absence but its inequality among economic agents.”

¹³⁹ See Sappington (1991): 49.

¹⁴⁰ See also Schmidt (1987): 501; Shleifer/Vishny (1997): 741.

¹⁴¹ See Barnea et al. (1985): 26; Saam (2002): 11.

¹⁴² See Barnea et al. (1985): 26.

¹⁴³ See Williamson (1973): 317; Perrow (1986): 14; Williamson (1998): 30f; Oppen (2001): 603; Saam (2002): 11f. In fact, if all players exhibited unbounded rationality, contracts between the parties were complete, leaving no room for agency problems. For a description of contracts, please see further below.

¹⁴⁴ See Pratt/Zeckhauser (1991): 2.

¹⁴⁵ See also Meinhövel (1999): 22f; Saam (2002): 19.

pects which can be distinguished into information asymmetry before (ex ante) and after entering the agency relationship (ex post).¹⁴⁶

The problem of hidden characteristics arises ex ante and describes the principal's problem to identify the best-qualified agent from a pool of potential agents which is heterogenous with respect to their qualification, ability or characteristics. While the agent knows its true qualifications, the principal does not have this information or can only acquire the information by incurring tremendous costs.¹⁴⁷ Thus, ex ante, the agent possesses private information¹⁴⁸ about his eligibility for the tasks to be performed on behalf of the principal. He can exploit this information asymmetry by projecting a false image of his qualifications by imitating highly qualified agents.¹⁴⁹ As a result, the principal faces the problem of uncertainty regarding the agent's true applicability, as he will learn the actual qualification of the agent only after the contractual agreement.¹⁵⁰ Therefore, hidden characteristics can result in the problem of adverse selection,¹⁵¹ also referred to as the lemon's problem¹⁵². The problem of adverse selection results in an inefficiency detrimental to both the principals and the highly qualified agents. Therefore, both parties are strongly incentivized to take measures in order to reduce these inefficiencies.¹⁵³ This involves screening by the principal and bonding by the agent.¹⁵⁴

The problem of hidden action arises after the contractual agreement. Having contracted the agent, the principal is unable to monitor the behavior and actions of the agent.¹⁵⁵ In addition, principals are not as well informed as agents with regard to what actions should best be taken.¹⁵⁶ As a result, the agent has an incentive to maximize his individual utility. The information asymmetry enables the agent to make any promise regarding his behavior and to later deviate from it without being penalized.¹⁵⁷ For example, he may reduce his effort while at the

¹⁴⁶ See also Stadler (2010): 74. In its later analysis, this thesis focuses on ex post information asymmetry.

¹⁴⁷ See Jost (2001): 28; Stadler (2010): 75.

¹⁴⁸ Private information relate to information about certain facts; the information can be privately observed by those who have access to it and is unobservable to those without access. See also Molho (1997): 1.

¹⁴⁹ See Jost (2001): 28.

¹⁵⁰ See also Saam (2002): 29; Stadler (2010): 75.

¹⁵¹ See Jost (2001): 28; Bhagat/Jeffers Jr. (2002): 10. Adverse selection refers to the problem that private information provide individuals with the opportunities and incentives to lie prior to the set-up of the contract. This can also be called "precontractual opportunism". Molho (1997): 8. See Holmstrom (1982): 324 and Levinthal (1988): 177 for alternative definitions of adverse selection.

¹⁵² Akerlof (1970): 489f describes a market for used cars in which the car's owner is usually better informed about the car's quality than the buyer. Hence, buyers are unable to judge the true quality of the used car prior to the purchase. The respective seller is aware of the car's quality, however, has no possibility to reliably signal the quality of the car. As a result, sellers of good quality cars will withdraw from the market. Consequently, only the cars of the poorest quality (lemons) are traded.

¹⁵³ See also Stadler (2010): 76.

¹⁵⁴ See Jost (2001): 28f. See also Jensen/Meckling (1976): 308.

¹⁵⁵ See Meinhövel (1999): 15; Witt (2001): 87. The resulting information asymmetry primarily refers to the agent's expended effort. See Arrow (1991): 38. Note that if the actions of the agent were observable for the principal, they would be included in the contract.

¹⁵⁶ See Levinthal (1988): 155.

¹⁵⁷ See also Spremann (1987): 6; See Jost (2001): 26.

same time pretending high effort.¹⁵⁸ With the agent's effort being unobservable, the problems faced by the principal are to provide incentives to and adequately share risk with the agent.¹⁵⁹

The problem of hidden action is augmented by the problem of hidden intention. This arises after the contractual agreement as a result of information asymmetries between the principal and the agent concerning the latter's intentions.¹⁶⁰ Given the principal's lack of knowledge with regard to the agent's intentions, the agent can secretly pursue its individual goals. Even if the principal learns about the agent's intentions, he may not always be able to cancel the agreement due to the costs he incurred during the contracting process (hold-up).¹⁶¹

After the contractual agreement, information regarding the nature of the external environment is not distributed symmetrically, resulting in hidden information (knowledge).¹⁶² Hence, even if the principal is able to observe the actions of the agent, he cannot assess his performance as he does not have information regarding the external environment within which the agent operates.¹⁶³ This is because the performance of the agent consists of two components:¹⁶⁴ (1) the agent's individual achievements and (2) random environmental influences that can either positively or negatively affect the agent's performance.¹⁶⁵ Assuming the agent is aware of the type of environmental influence, he will use this information against the interest of the poorly informed principal who may observe the actions of the agent, however, cannot differentiate between bad luck¹⁶⁶ and low effort.¹⁶⁷ This problem can be aggravated if the agent consciously withholds information.¹⁶⁸ A possible solution to the hidden information problem constitutes signaling, which can be regarded as a knowledge transfer from the agent to the principal, and screening, which refers to the generation of knowledge by the principal.¹⁶⁹

Incomplete contracts constitute the direct result of information asymmetries. Due to asymmetric information, individual actions and intentions of the agent cannot be monitored and the nature of the external environment cannot be observed. Hence, the principal cannot design a complete contract specifying the actions of the agent under each state of nature.¹⁷⁰ Moreover,

¹⁵⁸ See also Saam (2002): 29.

¹⁵⁹ See Rees (1985b): 83f.

¹⁶⁰ See Stadler (2010): 78.

¹⁶¹ See Saam (2002): 29.

¹⁶² See Witt (2001): 87. The concepts of hidden action and information can also be combined, resulting in only three manifestations of information asymmetry. See e.g. Leiber (2008): 78. Hidden action and hidden information are regarded as giving rise to moral hazard. Moral hazard occurs when "one agent can observe the joint effects of the unknown state of the world and of decisions by another economic agent, but not the state or the decision separately." Arrow (1969): 7. This can also be called "postcontractual opportunism". See Molho (1997): 8. See Holmstrom (1982): 324 for an alternative definition of moral hazard.

¹⁶³ See Stadler (2010): 77f.

¹⁶⁴ See also Milde (1987): 40.

¹⁶⁵ Spremann (1987): 11f calls this environmental influence an "exogenous risk the probability of which neither principal nor agent can control."

¹⁶⁶ Bad luck can be defined as unfavorable, observable shocks to firm performance beyond the agent's control. See Bertrand/Mullainathan (2001): 901.

¹⁶⁷ See e.g. Spremann (1987): 10, 12; Levinthal (1988): 156; Molho (1997): 119f; Jost (2001): 30.

¹⁶⁸ See Neus (1989): 17.

¹⁶⁹ See Meinhövel (1999): 15. Both solutions imply costs, which are described in section 2.1.5.

¹⁷⁰ See Holmström (1979): 74, 89; Scharfstein (1988): 186. However, "essentially any imperfect information about actions or states of nature can be used to improve contracts". Scharfstein (1988): 186.

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2015, XXXVI, 462 p., Softcover

ISBN: 978-3-658-11401-5